DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0826
Corporate Income Tax
For Tax Years 2000, 2001, 2002, 2003, 2004

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ISSUES

I. Adjusted Gross Income Tax – Sales Apportionment Methodology.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-4-2; IC §6-8.1-5-4; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-6-10; IC § 4-21.5-2-4; IC § 4-21.5-1 et seq; IC § 4-22-2-3; 45 IAC 3.1-1-37; 45 IAC 3.1-1-39; 45 IAC 3.1-1-62; 45 IAC 15-4-1; Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); Meyer Waste Systems, Inc. v. Ind. Dep't of State Revenue, 741 N.E.2d 1 (Ind. Tax Ct. 2000); CBS Inc. v. Comptroller, 575 A.2d 324 (Md. 1990); Metromedia, Inc. v. Director, Division of Taxation, 478 A.2d 742 (N.J. 1984).

Taxpayer is protesting the Department's use of the "audience factor" apportionment method to determine the tax due on income derived from certain television stations which broadcast in Indiana.

II. Adjusted Gross Income Tax – Combination – Entities Added to Indiana Return.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-2; 45 IAC 3.1-1-38.

Taxpayer protests the inclusion of two media companies in its Indiana consolidated returns for the years at issue.

III. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2; IC § 4-22-2-3; IC § 4-21.5-1 et. seq.;

Taxpayer protests the imposition of a ten percent negligence penalty.

IV. Tax Administration – Underpayment Penalty.

Authority: IC § 6-3-4-4.1.

Taxpayer protests the imposition of a ten percent underpayment penalty.

STATEMENT OF FACTS

Taxpayer is a major media corporation engaged in television and motion picture production and distribution, and television broadcasting, among other businesses. Taxpayer filed consolidated adjusted gross income tax returns in Indiana for the tax years. The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer for the years 2000 through 2004. As a result of the audit, the Department made several proposed adjustments which resulted in the assessment of additional income tax as well as interest and penalty. Taxpayer protested some of the adjustments, as well as the imposition of penalty. A hearing was held on Taxpayer's protest and this Letter of Findings results. Additional information will be provided as necessary.

I. Adjusted Gross Income Tax – Sales Apportionment Methodology.

DISCUSSION

Taxpayer protested the Department's proposed assessment of additional income tax based on the use of the "audience factor" apportionment methodology in lieu of the "cost of performance" apportionment methodology Taxpayer used, arguing that the "cost of performance" method has not been adopted in Indiana either by statute or regulation. Taxpayer argues that IC § 6-3-2-2(f) "clearly and unambiguously" requires companies with revenue from sales, other than sales of certain intangible property or tangible personal property, to apportion such revenue using a cost of performance. Taxpayer then cites to 45 IAC 3.1-1-62 to argue that the Department did not have the authority to apply its equitable remedial powers under IC § 6-3-2-2(l). Taxpayer states in its October 5, 2009, protest letter:

> The regulation further required that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Indiana imposes the adjusted gross income tax ("AGIT") on every corporation's adjusted gross income ("AGI") derived from sources within Indiana. IC § 6-3-2-1(b). When a corporation derives business income from sources both within and without Indiana, the business income derived from sources within Indiana is determined by an apportionment formula. See IC § 6-3-2-2(b). The term apportionment refers to the division of multistate income among the states by use of a three factor, or any other approved formula. 45 IAC 3.1-1-37.

Indiana's three factor formula multiplies the income derived from sources both within and without Indiana by a fraction, the numerator of which is a property factor plus a payroll factor plus a sales factor, and the denominator of which is three. IC § 6-3-2-2(b). The numerator of each factor represents business conducted in Indiana, and the denominator of each factor represents business conducted everywhere. Said differently, three factor

apportionment calculates the mathematical average of three ratios: (i) intrastate property to property everywhere; (ii) intrastate payroll to payroll everywhere; and (iii) intrastate sales to sales everywhere. Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766, 771–72 (Ind. Tax Ct. 1999).

Excluding income from the numerator of an apportionment factor lowers the percentage of a company's income that is apportioned to a state; adding income to the numerator increases the percentage of a company's income that is apportioned to a state. Apportionment disputes arise because, among other reasons, a company excludes income from the numerator of a factor and a state believes such income should be included in the numerator of the factor.

In rare cases, three factor apportionment does not fairly represent a corporation's income derived from sources within Indiana. Accordingly, the General Assembly has identified two circumstances in which the Department is empowered to equitably apportion a corporation's income to fairly reflect the income from sources in Indiana.

IC§ 6-3-2-2(l), which says:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting;
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> (2) the exclusion of any one (1) or more of the factors;
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> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
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> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.
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> (Emphasis added).

The second circumstance is at IC § 6-3-2-2(m), which says,

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

IC § 6-3-2-2(p) pertains to the Department's power to require two or more businesses to file a combined Indiana income tax return.

Consistent with the Department's statutory power to equitably apportion multistate income, see IC § 6-3-2-2(l), the Department's rules say that three factor apportionment applies unless the Department requires "the use of a different formula which more fairly reflects" the corporation's income from Indiana sources. 45 IAC 3.1-1-39. The Department will equitably apportion a corporation's income if the corporation's reporting method (i) does not "fairly represent" the corporation's Indiana income; or (ii) results in an "arbitrary division" of income; or (iii) "in other respects does not fairly attribute income to this state or other states." 45 IAC 3.1-1-62 (citing IC § 6-3-2-2(l)). In such cases, "the Department may require the use of a more equitable formula for determining Indiana income." 45 IAC 3.1-1-62. "It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results." Id.

The present dispute starts with the sales factor of Indiana's three factor apportionment formula. In relevant part, Indiana's sales factor says:

> The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property.... Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter....
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> IC § 6-3-2-2(e).
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> Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if:
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> (1) the income-producing activity is performed in this state; or
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> (2) the income-producing activity is performed both within and without this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.
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> IC § 6-3-2-2(f).
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> Taxpayer argued that its services originate primarily in two states outside Indiana, and that, therefore, the income producing activities related to affiliate and advertising revenue are located in those states. However, as the Department's audit points out, both of these states' laws tie this revenue to where the programming is delivered and apportion accordingly among the states; i.e., neither state taxes the portion of income that is derived from television viewers in other states. The Department's auditor requested from Taxpayer documentation that would include the 50-state apportionments necessary to determine the nature and types

of revenue earned, but Taxpayer failed to provide these documents. The Department's audit reviewed sample contracts and found that the amount of revenue received from cable and satellite operators was determined by some combination of total number of individual subscribers serviced by the cable and satellite operators and the popularity of the programming (please see Section II of this Letter of Findings for further discussion of the contracts). Therefore, the Department's audit concluded that the "audience factor" more fairly reflects Indiana income since revenues earned by Taxpayer are based on the number of subscribers and is consistent with the use of "audience factor" in other states such as the states where Taxpayer claims these receipts ought to be allocated under Indiana law.

The law grants the Department the right to see a taxpayer's books and records, and taxpayers have a duty under threat of fine and prison criminal penalty to allow such inspection. The Department, to do the job the General Assembly gave it, is not required to rely on a taxpayer's self-serving statements or hearsay. See IC §§ 6-8.1-4-2(a)(3); 6-8.1-5-4(c); 6-3-6-10(a); 45 IAC 15-4-1. Cf. Meyer Waste Systems, Inc. v. Ind. Dep't of State Revenue, 741 N.E.2d 1, 6–7 (Ind. Tax Ct. 2000) (holding that, because the only supporting evidence with which the petitioner provided the Court was the petitioner's own testimony, then such "self-serving assertion without more is not probative evidence"). It is undisputed that Taxpayer and its referenced affiliates are members of the same combined group of corporations. Taxpayer did not provide crucial documentation the Department's auditor requested including the 50-state apportionments necessary to determine the nature and types of revenue earned. Consequently, the Department's audit was prepared based on the "best information available" using the Nielsen's audience factor ratio to apply income attributable to Indiana.

45 IAC 3.1-1-62, the referenced regulation, states:

Special Formulas for Division of Income. All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. **It is anticipated** that these situations will arise only in limited and unusual circumstances (which **ordinarily** will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

(Emphasis added).

By using the audience factor, the Department reasonably resolved Taxpayer's failure to provide requisite documentation. Taxpayer's books and records could have provided the information that would have permitted the Department to use three factor apportionment in this case. But because Taxpayer did not do so, the auditor could not ensure that the Indiana source income of the Taxpayer and its affiliates could be fairly represented by three factor apportionment. The auditor therefore used "the best information available," i.e., the ratio of Indiana cable and satellite subscribers (who ultimately make Taxpayer's broadcasts valuable) to all cable and satellite subscribers nationwide. Under the circumstances, it was reasonable for the auditor to use the Hoosier subscriber base to derive a ratio by which to apportion Taxpayer's income.

Here, the Department simply followed the rules outlined in IC § 6-3-2-2(l) and 45 Indiana Administrative Code 3.1-1-39 & -62, which govern the interpretation of Indiana's sales factor when uncontemplated apportionment issues are presented. Taxpayer and its affiliates are members of a combined group of corporations; the Department certainly did not contemplate that the group withhold certain books and records. By using the audience factor to apportion the Taxpayer's and its affiliates' income, the auditor resolved the issue.

Taxpayer reads the language of limitation expressed in the regulation too narrowly. Clearly, the regulation strikes a cautionary note against the Department implementing its remedial powers broadly, however the statue's language of limitation suggests a tolerance for "limited and unusual" circumstances which are only ordinarily unique and non-recurring; i.e., the circumstances may also be non-unique and recurring. The "audience factor" method of apportionment is being applied to a limited and unusual situation in the matter before the Department. The Department has the authority to apply IC § 6-3-2-2(l) to effectuate a result that more fairly represents taxpayer's income derived from sources within the state.

The plain language of the law states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana... the department may require, in respect to all or any part of the taxpayer's business activity... the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." IC § 6-3-2-2(l) (Emphasis added). The "audience factor" is an appropriate method to effectuate an outcome that more equitably reflects the taxpayer's income from Indiana sources.

Taxpayer also argues that the Department's application of the audience factor violates the state's Administrative Procedure Act ("APA"). IC § 4-22-2-3(b) defines a "rule" as "the whole or any part of an agency statement of general applicability that: (1) has or is designed to have the effect of law; and (2) implements, interprets, or prescribes: (A) law or policy; or (B) the organization, procedure, or practice requirements of an

agency." Taxpayer argues that the method applied by the Department on audit constituted a rule under this definition. In further support of this argument, Taxpayer cites to state supreme court cases from Maryland and New Jersey where the courts upheld an argument similar to Taxpayer's (see CBS Inc. v. Comptroller, 575 A.2d 324 (Md. 1990) and Metromedia, Inc. v. Director, Division of Taxation, 478 A.2d 742 (N.J. 1984)). Taxpayer further points out that the reference in the Department's audit to "agency action" under IC § 4-21.5-1 et seq. is not applicable since the Department is not subject to this article. On this latter point, Taxpayer is absolutely correct, the Department is not subject to IC § 4-21.5. IC § 4-21.5-2-4(a)(9). However Taxpayer's argument that the Department's application of the "audience factor" method violates APA is not correct, since the Department is applying IC § 6-3-2-2(l) and has been consistent in its application to Taxpayer and other similarly situated taxpayers. Lastly, other states' interpretations of their laws, while interesting, hold no precedential value in Indiana; and Indiana courts have not considered whether the use of the "audience factor" apportionment methodology constitutes a rulemaking action.

Pursuant to IC § 6-8.1-5-1(b), Taxpayer has not met its burden to show why the "audience factor" method of apportionment does not fairly reflect Taxpayer's corporate income from Indiana sources and why the "cost of performance" method would more fairly reflect Taxpayer's income.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax – Combination – Entities Added to Indiana Return.

DISCUSSION

The Department found that Taxpayer did not include two subsidiary cable networks in its Indiana consolidated tax returns during the 2003 and 2004 tax years. The Department determined, under the authority of IC § 6-3-2-2(a), that Taxpayer had not properly reported income from licensing films and television shows to broadcast and cable networks which were then viewed on those networks by Indiana residents in their homes.

The Department's audit describes the first entity ("E1") and ("E2") as cable programming providers that provide 24-hour per day network programming services to Indiana residents principally through 3rd party cable operators. The programming services include the production, creation, editing, and packing of the cable television programs. E1's network includes a 24-hour a day, advertising-supported satellite delivered programming service, a digital television station channel, and a network station – all well-known and with significant viewership across the country. E2 provides similar programming services. Revenues from the cable networks are generated from advertising sales and affiliate fees. The sale of advertising time includes both local and national advertising. Affiliate fees are from cable television operators, DTH satellite operators, and other distributors.

Again, the Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1.

IC § 6-3-2-2(a) states:

With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

(1) income from real or tangible personal property located in this state;
(2) income from doing business in this state;
(3) income from a trade or profession conducted in this state;
(4) compensation for labor or services rendered within this state; and
(5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

45 IAC 3.1-1-38 defines "doing business in the state:"

Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

(1) Maintenance of an office or other place of business in the state
(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
(4) Rendering services to customers in the state
(5) Ownership, rental or operation of a business or of property (real or personal) in the state
(6) Acceptance of orders in the state
(7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.

As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC § 6-3-2-2(b)-(n). (Emphasis added).

Taxpayer claims that because these subsidiaries had neither a physical location nor personnel in Indiana it should not be taxed on these subsidiaries. Taxpayer provided a representative sample agreement between a

company similar to E1 and E2 ("E3") and a cable operator ("Operator"). The agreement states the following in its prefatory language:

> WHEREAS, the parties hereto desire that [E3] provide the [E3] Services to Operator and that Operator market and transmit such [E3] Services on a limited, non-exclusive basis, via Operator's cable television systems to authorized subscribers. . .

The agreement, in paragraph 7.01, describes the fees due to E3 to mean "the monthly amount charged to Operator by [E3] for the right to exhibit the [E3] Services over Operator's System on a per-Subscriber and per-[E3] Service basis...." Appendix A of the agreement set forth complex formulas for calculating the fees.

In other words the Operator is but a conduit for the programming services that E3 provides in a particular defined geographic region. And E3's revenue is gauged by the number of residents in that defined geographic region and the number of E3 programs they receive. The same applies for E1 and E2, thus these two companies are "rendering programming services" in Indiana and are therefore "doing business" in Indiana.

At the hearing Taxpayer disagreed with the above characterization of the Operators' fees stating that the fees were not calculated based on the number of Indiana subscribers, but rather based on the Operators' total subscribers. Granted the agreement does provide the signator Operator the option of an "Unlimited Guaranteed Penetration Ratio" which is based on a percentage of an Operator's "Unlimited Households," however even that is combined with minimum guaranteed penetration ratios, so while a more attenuated connection to Indiana residents, it is nonetheless still tied to the state's residents subscriptions to E1 and E2's services. Furthermore, this is merely an option by which operators may elect to agree to calculate the fees they pay E1 and E2. In the representative sample agreement Taxpayer provided, the operator had elected not to calculate using this method.

Taxpayer has not overcome its burden to show that the Department's audit's inclusion of E1 and E2 on Taxpayer's return is incorrect.

FINDING

Taxpayer's protest is respectfully denied.

III. Tax Administration – Negligence Penalty.

DISCUSSION

The Department issued ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

> The department shall waive the negligence penalty imposed under IC § 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer has met its burden of proof to show that the deficiencies they incurred are due to reasonable cause and are therefore not subject to a penalty under IC § 6-8.1-10-2.1(a).

FINDING

Taxpayer's protest is sustained.

IV. Tax Administration – Underpayment Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent underpayment penalty for the tax years in question under IC § 6-3-4-4.1(d). Taxpayer protested the imposition of underpayment penalty.

IC § 6-3-4-4.1(d) states:

> The penalty prescribed by IC § 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:
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> (1) the annualized income installment calculated under subsection (c); or
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> (2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.
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> In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25 [percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

Taxpayer has provided sufficient documentation demonstrating that the imposition of the underpayment

penalty is not appropriate.

FINDING

Taxpayer's protest of the underpayment penalty is sustained.

CONCLUSION

Taxpayer's protest of the negligence and underpayment penalties is sustained. Taxpayer is denied on the remaining issues of its protest.

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